ECONOMIC PROSPECTS AND CONDITIONS OF CROWDFUNDING

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Abstract:
This paper aims to present the conception of crowdfunding – the relatively new idea of raising funds from individuals which is made online by means of a web platform. Intent of this method is the ability to collect, manage and distribute finance using information and communications technology in order to develop particular project in exchange for provision of benefits. Article analyses and expands knowledge about essence of crowdfunding concept, its main types and characteristics. The subject of discussion of this paper are economic conditions for the application of social financing as a source of capital. The authors objective is to juxtapose the incentives and disincentives for both creators and funders. Crowdfunding as all other methods of raising capital is an action that carries risk. Novelty of the approach is researched through the prism of values that characterises all sources of capital. This article lead to the conclusion that main value of the method is to increase the probability of obtaining more beneficial solutions from the community than from the enterprises offering outsourcing services. Well-organized process of crowdfunding can finance start-ups and increase investment opportunities especially for small and medium enterprises.

Keywords: crowdfunding, wisdom of crowds, start-ups

1. INTRODUCTION

Fast and global spread technological developments influence our daily lives. Dynamic development of the Internet has change the way people communicate, obtain information and conduct business. Development of Web 2.0 concept, online payment systems, social networks enable materialization of numerous concepts used in various types of electronic platforms. This ability for people to communicate and interact with each other has been crucial for the recent emergence of crowdsourcing. The amount of knowledge and talent dispersed among the numerous individuals has the capacity to create the mechanism by which these assets can be matched to those in need of it (Howe, 2008, p.1). Difficulties in attracting external finance is a constant problem that new firms face in their initial stage entrepreneurial initiative. Many ventures remain unfunded, partly due to lack collateral and sufficient cash flows and partly because of unsuccessful attempts to convince investors (Belleflamme & Lambert & Schwienbacher, 2013, p. 4). Nowadays entrepreneurs have started to rely on the Internet to seek financial support for their projects enabling global reach to attract funding.

Crowdfunding is seen as a viable and alternative way to raise funds which occurs online by means of web platform. Alternative approach of funding is based on financial help of general public (the crowd) instead of specialized investors such as banks or venture capital funds (Schwienbacher & Larralde, 2010, p. 3). Determination of economic outlooks and conditions seems to be crucial in terms of evaluating crowdfunding as a fundamental transformation in the way that start-ups, micro-enterprises and small and medium enterprises (SME’s) access funding.

2. THE IDEA AND DEFINITIONS OF CROWDFUNDING

The concept of crowdfunding derives from crowdsourcing, which describes the process of outsourcing tasks to a large, often anonymous number of individuals the “crowd” in the form of open call application to obtain ideas, feedback, assets, resources, knowledge and expertise to develop corporate activities (Hemer, 2011, p. 8). The term “crowdsourcing” was first used in 2008 by Jeff Howe and Mark Robinson. In the same year F. Kleemann presented more complex definition: “*crowdsourcing takes place when a profit-oriented firm outsources specific tasks essential for the making or sale of its product to the general public (the crowd) in the form of an open call over the internet, with the intention of animating individuals to make a [voluntary] contribution to the firm's production process for free or for significantly less than that contribution is worth to the firm*” (Kleemann, 2008, p. 6). Referring to this definition explanation of the subject matter can be offered in that way: “*crowdfunding involves an open call, mostly through Internet, for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes*” (Bellaflamme, Lambert & Schwienbacher, 2013, p. 8). Crowdfunding is a form of financing of various projects or a venture by the community which is group of individuals instead of professional parties like banks, venture capitalists or business angels. The project is funded in this case by the large number of small, one-time payments made by persons interested in the project. Dissemination of the Internet allows for easy communication of projects and create community around them, which contributed to the development of the crowdfunding phenomenon. The term is usually used to refer to collections carried out for this purpose created online platforms, less frequently, with the help of social networking sites or blogs. Explanation of the term varies depending on the authors’ approach to the issue. Crowdfunding can be perceived as a process of raising money to help turn promising ideals into business realities by connecting investees with potential supporters. Nowadays crowdfunding is a Internet-based method of fundraising in which individuals solicit contributions for projects on specialised websites. Other notions of crowdfunding emphasizes financial mechanism and capital formation strategy as a source of funding for start-ups, micro-enterprises and small and medium sized enterprises (SMEs).

Historically crowdfunding functioned before the emergence of the term. First well-known act of Internet-based money raising was the one realised in 1997 by British rock band Marillion which used fan campaign to collect 60 thousand USD, which was allocated to organize US tournée. The whole enterprise was conceived and managed by fans without any involvement by the band, although band used the idea for financing future albums recordings and marketing. Proper development of crowdfunding conception took place in years of 2005-2009 when platforms like: Sellaband.com, Kickstarter.com, Zopa.com, IndieGoGo.com, Kiva.org were implemented (Dziuba, 2012, p. 84).

2.1. Crowdsourcing and crowdfunding – similarities and differences

Crowdsourcing can be used in both commercial and non-commercial actions. Wikipedia is one of the best examples of non-commercial form of crowdsourcing. There are four different ways crowdsourcing works:

- Enables to access large online labour force, indentify selected workers, post work and letting workers find it
- Asking the crowd to find the solution to a problem
- Helping find existing knowledge and organize it
- Ideals and opinions from the crowd and feedback.

Crowdsourcing is distributed problem solving which offers some significant benefits like: access to flexible workforce, broad access to creative talent, increased cost-effectiveness and business capabilities, reduces time-to-market and faster project delivery. Crowdfunding focuses on providence of money for a particular purpose by a large group of people. It offers a hosts of benefits as: access to capital with hedged risk, works as a marketing tool, provides easier source of funding than traditional channels, introduces potential loyal customers, develops free PR and an opportunity for advance sales. The convergence of the two concepts results from the methods of communication and access to mass groups of participants. Dissimilarities flows from the purpose of participants activities and focusing on specific methods of rewarding and motivating.

To sum up the description of crowdfunding emphasize should be put on its economical dimension and abilities to exploit the capabilities of social networks and other new features of Web 2.0, especially the function of viral networking and marketing which enables the mobilization of a large number of users in specific Web communities within a relatively short period of time (Hemer, 2011, p. 8). This concept is realized through the electronic platform, which function include advertising jobs projects, monitoring their implementation, creating interaction between market participants, providing systems payment and reward participants (Dziuba, 2012, p. 84). Crowdfunding involves close cooperation of investors, intermediaries and entrepreneurs. Crowdfunders or backers (donors, sponsors, clients, lenders/creditors) and capital seeking ventures are basic actors in the crowdfunding process.

3. CATEGORIZATION OF CROWDFUNDING PLATFORMS

In business practice crowdfunding facilitates the raising of capital for a variety of purposes, using numerous variations of the models. There are four main categories (with several modifications) of crowdfunding platforms (CFP's) which appear in the present studies and literature:

- *Investment crowdfunding*
- *Lending-based crowdfunding*
- *Reward-based crowdfunding*
- *Donation-based crowdfunding*

Equity/investment type is the collective effort of individuals who network and pool their money, usually via Internet to investing for equity, or profit/revenue sharing in businesses or projects. Contributors are rewarded an equity stake in a company in return for their investment. The value preposition being offered is company ownership or voting rights (Gulati, 2014, p. 4). This embodiment provides range of solutions to assist start-ups and companies in early stage of development. Project initiators and their partner platforms define o time period and a target amount of money which serves as a threshold (Hemer, 2011, p.16). Money target is divided into equal slices which are offered via the platform as equity shares (or stocks) to the crowd at fixed prices. Collecting money lasts until the threshold is reached and then investment phase begins.

In this type of crowdfunding three models can be recognized. First is *collective investment* which combine the assets of various individuals (e.g. *business angels*), and organizations to create a larger, well-diversified portfolio. In return investors expect dividends or share in future profits. *Business angels* investments require a high return rate as they are at high risk (Dziuba, 2012, p.87). Second is *investment fund* which can be defined as a supply of capital belonging to numerous investors that is used to collectively purchase securities while each investor retains ownership and control of own shares. Benefits in the form of shares allow to separate distinct *securities-based (equity)* model. Securities-based funding gives ownership, or a promise of future revenue to investors in equity or debt. This model implies the sale of shares and transfer property rights to online investors. Internet platforms with the most technological advancement support equity-based model.

All investment models are selected by mutually overlapping criteria of allocation which consist:

- range of benefits achievable by investors
- value of invested funds
- organizational form of the project
- use of technology.

Out of all crowdfunding models *equity-based* produce the largest amount of funds raised on a per-project basis (Crowdfunding Industry Report, 2012, p. 20), although this form of model has been the slowest to grow due to regulatory restrictions that relate to this type of activity.

Lending-based crowdfunding enables the direct borrowing of funds, bypassing the traditional financial institutions, such as banks. This type of crowdfunding is largely an evolution of the peer-to-peer model of lending pioneered by firms such as Landingclub and Zopa. Two approaches can be distinguished: *microfinance (P2P microfinance)* and *social lending (P2P lending)*. Peer-to-business resembles micro-financing so projects and businesses seeking debt apply through the platform uploading their pitch, with members of the crowd taking small chunks of the overall loan. Micro-lending solution is a financial aid usually used by the poorest, offered in small amounts, collected and distributed by non-profit and social focused platforms. Others like *social lending* operate as an investment – free funds are allocated and lent to certain rules. Payment plus interest might be returned in a lump sum or along some sort of payment schedule (Gulati, 2014, p. 5). Social lending relate to higher amounts making it the second largest category of world crowdfunding market, as measured by the monies raised. Crowd lending is considered a threat to the big lending businesses as global banks.

Donation-based crowdfunding is in practice the most widespread model. Its essence is a platform (website) to communicate with the crowd of participants and reporting of project offers, such as the collection of funds for a specific, philanthropic goal or social sponsorship In this model participants are not rewarded.

Reward-based (sponsorship model) crowdfunding allows people receive non-financial rewards in return for their contribution to projects. Donors are offered usually low-value items like: t-shirts, CD's, books, tickets for cultural events (which are often subjects of rebounds). Often this type of funding is tiered which means the more participant will donate the better reward he will receive. Sponsorship systems tend to focus on supporting the creative projects or units. Participants from the network "crowd" invest their funds in the project (for example, musical activities, film production, the organization of the concert, the idea of the book), in order to support them. Fundraising for the project is clearly defined time, usually takes a few weeks to several months. Entrepreneurs or artists crowdfund the production cost of their record, movie, game or product and allow the donors to be first recipients one the production is complete (Introduction to crowdfunding, 2012, p. 3).

In sponsorship crowdfunding can be distinguished three models of rewarding of market participants. First *All-or-Nothing* – when the fund-raising period is over and the project was not realized - invested funds are going back to the donator reduced by the collected fees.

Second *Keep-it-All* used in IndieGoGo.com platform is the solution when entrepreneur can keep all the funds collected (minus commission) whether the project goal is reached or not. If funds collected are insufficient meet the project goals, refunding decision it is up to entrepreneur, however commission is higher in such circumstances.

Table 1: Comparative summary of crowdfunding models

	Form of contribution	Form of return	Motivation of funder
Donation Crowdfunding	Donation	Intangible benefits	Intrinsic and social motivation
Reward Crowdfunding	Donation/ Pre-purchase	Rewards but also Intangible benefits	Combination of Intrinsic and social motivation and desire for reward
Crowd funded Lending	Loan	Repayment of loan with interest. Some socially motivated lending is interest free.	Combination of Intrinsic, social and financial motivation
Equity Crowdfunding	Investment	Return of investment in time if the business does well. Rewards also offered sometimes. Intangible benefits another factor for many investors.	Combination of Intrinsic, social and financial motivation

Source: Introduction to crowdfunding, 2012, p. 2.

4. FACTORS INFLUENCING THE USE OF CROWDFUNDING

Crowdfunding is based on the close cooperation between three primary actors: a) entrepreneurs who can be described as creators, b) investors who can be described as funders, and c) platforms which can be called intermediaries. Process of choosing the best solution for financing the company should be carried out taking into account several factors. Engaging crowdfunding for a business project have advantages (incentives) and disadvantages which can be described as challenges, risks and disincentives. We describe each of them dividing on participants.

4.1. Entrepreneur incentives

Main benefits that can be achieved through choosing crowdfunding rather than traditional channel of financing are: lower *cost of access to capital and access to extensive information system which contains: knowledge, diversity of thoughts, innovation and breakthroughs, testing the marketability*.

Access to financing via crowdfunding enable creators to reduce the cost of planned enterprise for several reasons. First is *better matches* – crowdfunding platforms give exact information about specified project. Creators can cooperate with those individuals who have the highest willingness to pay for equity in their venture or for early facilitated access to their new product (Agrawal, Catalini & Goldfarb, 2013, p.11). Potential funders have the possible full information via Internet and can decide whether project is in their interest or not. This way entrepreneurs process of fundraising is not limited to local traditional offline mechanisms. Funding via online crowdfunding creates a great advantage in the absence of geographical boundaries - people interested in the project can support it from any part of the world via specialized Internet platforms. Non-equity-based crowdfunding like early access to products, recognition for discovering innovations, participating in a new venture's community of supporters and other non-financial rewards encourage individuals to financial backing. Crowdfunding campaigns provide a number of benefits beyond strict financial gains:

- *Wisdom of the crowd* is the process of taking into account the collective opinion of a group of individuals rather than a single expert to answer a question. The crowd can serve the same function as board of directors or external company consultants
- Marketing – project creators can show there is an audience and interest on market for their enterprise what provides good market feedback
- Profile – boost of reputation via compelling project which encourage a big spectrum of supporters
- Feedback/audience engagement – offering early-stage access to content of entrepreneur activity give possibility for a wider spectrum of knowledge and opinions at early levels, which

provide the chance to facilitate and improve final product or service before introduction to the market. Such actions increase achievement of desired success.

4.2. Funder incentives

Crucial aspect of crowdfunding is the question of compensation, acknowledgement or rewards for potential supporters (Hemer, 2011, p. 13). Crowdfunders' motivation to participate in investments can be divided into economical and intrinsic incentives. Equity crowdfunding give opportunity to participate in such material rewards as: shares of the venture, certificates, debt securities, dividends and/or voting rights. This type of funding is purely classical economical line of thinking – single-minded interest of future financial outputs. Crowdfunding for financial return like equity-based and lending-based models can be considered as rational economic approach, however it must be emphasized that the funders are not primarily motivated by material rewards. Range of intrinsic motives can be as listed by J. Hemer:

- Supporting and contribution to socially important mission, idea or product and service – some funders are willing to participate in projects without receiving a tangible reward in order to be a part of something that they consider to be valuable
- Personal identification with the project's subject and its goals
- Satisfaction from being part of certain community with similar priorities which they value
- Satisfaction from observing the realisation and success of the project funded
- Enjoyment in being engaged in and interacting with the project's team (e.g. direct communication)
- Enjoying contributing to an innovation or being among the pioneers of new technology or business
- The chance to expand one's own personal network
- The expectation of attracting funders in return for one's own crowdfunding project

4.3. Platform incentives

Crowdfunding platforms usually are oriented for profit-business. The main purpose of such platform is to gather and connect people with a common goal in order to raise funding and make this goal become a successful project. The revenue of platforms comes from transaction fees form projects successfully completed. In the best interest of people who administrate such platforms is to create an environment which is able to attract a large community of funders and creators and facilitate efficient matching between ideals and capital (Agrawal, Catalini & Goldfarb, 2013, p.16). Crucial matter is safety of funders and creators who act in online environment therefore solutions reducing fraud should be an integral part of platforms.

4.4. Disincentives for creators and funders

Although crowdfunding present undoubted benefits, it also comes with a number of potential risks, barriers and challenges. The most dangerous are:

- *General public disclosure requirement connected with intellectual protection*. Many interactive developers and innovators are reluctant to announce the details of a project before production due to theft and protecting their intellectual property from imitation and plagiarism. Disclosing innovations and ideas in a public forum allow market competitors accessing to a rich source of information about rivals and may have negative repercussions on intellectual property protection. In that situation entrepreneur have to balance between need of raising capital and threat of overtaking idea by other market participants.
- *Public fear of abuse.* Lack of regulatory framework may become a barrier to public engagement
- *Risk of failure to meet campaign goals.* It is often easier to raise the money for a project than make a project of success. Negative impact of such event may lead to lower reputation of entrepreneur which may cause future lack of interest from potential funders.
- *One-time funding and donor exhaustion.* Investors often sign up for to invest in a particular project once. Crowd funded business owners have luck when donators support their idea throughout the entire process – such performance gives ability for creators to get to higher level of enterprise.

- *Risk of fraud.* Overly optimistic funders may be exposed to outright fraud or financial participation to projects which from the beginning are doomed to failure. False pages that look like authentic fundraising campaigns attract inexperienced investors promising significant benefits. Like with any online financial transaction, phishing schemes can be used to illegally gain access to personal and financial information (Gulati, 2014, p.7). Often when investment amounts are small individuals have weak incentives to perform due diligence.
- *Risky nature of small projects.* Early-stage projects (e.g. start-ups) present usually higher rate of failure in comparison with other businesses (Valencine & Jegeleviciute, 2013, p. 46). Financing through crowdfunding may be perceived as an easier way in comparison to venture capital therefore entrepreneurs can wrongly appraise success of their project. Such misjudgement may lead to information asymmetry between creators and funders which increase cost of risk.
- *Legal restrictions.* Development of the analyzed systems is conditioned by numerous legal restrictions. Special legislative conditioning concern equity-based crowdfunding - the regulators determine whether such a solution is possible, how many investors may be shareholders of the company, which amount to invest. In the U.S., until recently, the business based on investment crowdfunding was illegal. The situation changed abruptly in March 2012 after the adoption of new laws called JOBS Act (Jumpstart Our Business Startups Act).

5. ROLE OF CROWDFUNDING IN START-UP FINANCING

As an introduction to this section we present several existing sources of financing in order to highlight main characteristics and opportunities of particular financing options. Such a juxtaposition may serve as an initial analytical tool in the selection of source of financing the project, depending on the conditions presented below.

Table 2: Types of financing ventures

Investor/type of financing	Stage on which most useful	Subject to the investment/ when applicable	Given in return	What is provided to the venture
Bank Loans	Usually later stages when lower risk is associated to the company	Ventures with hard assets, non-technology-based companies	Loan repayment and Interest	Funds
Leasing Companies	Usually later stages of operating in the market	Low involvement of own capital	Lease payments	Consumer objects (equipments), real-estate (office space)
Government Agencies	Usually later stages	Subsidy for particular projects to improve economic system	Implementation of the economic policy of the country	Non-refundable capital, tax relief, cash bonuses
Bootstrapping	Early stages, not sufficient in the case of growth	Entrepreneurs not sure of the markets for their products, entrepreneurs with a specific mind-set and the "try-it, fix-it approach"	N/A	Independence from external investor, flexibility, time for learning for an entrepreneur
Business angels	Often already at seed-level stage, early stage	Close-to-home companies, industries they have experience with, ventures with big potential for growth	Equity ownership, return on an investment (more favourable conditions than venture capitalists)	Funds, support, expert advice
Venture capitalists	Later stages e.g. beginning of an innovation's commercialization	High-grow market segments, advanced level of management	Equity ownership, high return on the investment, preferential treatment	Funds, in some cases support
Other companies/ strategic investors	Advances stages	Actions to increase demand for the shares of the company	Increase in share price, long-term development strategy of company	Management knowledge, know-how, funds
Crowdfunding	Initial stages	Variety of projects and ventures, variety of sectors, even high-growth start-ups	Rewards or equity	Funds, feedback, support, evaluation of an idea

Source: Schwienbacher & Larralde, 2010, p. 9.

For capital-starved start-ups crowdfunding may be solution for an urgent need to obtain funding at perhaps the most difficult point - getting the business off the ground (Spellman, 2014, article 1), especially when traditional financing in the form of credit is not taken into account. Start-up companies usually carry more risk and have higher rate of failure in comparison with other businesses therefore venture capitalists and angel investors find that initial stage unattractive. Economical upward potential is a decisive factor when the question arises whether crowdfunding can become a realistic option among the spectrum of instruments for financing start-ups (Hemer, 2011, p. 26). Start-up enterprises can occur in any industry, but are most often associated with new technologies. As mentioned one of the most difficult moments of a start-up's life is the early phase funding. Many good ideas, concepts and prototypes never get the needed initial funding to prove the concepts' worth and make it to the next funding rounds. (Ahvenainen, 2010, p. 2) That's why one of the most effective ways to support start-up business is to get the early phase funding work better. Crowd-funding is one key tool in this progress, however it seems only innovative projects or ventures from the creative industry and on technology-, science-, or knowledge-based start-ups have a real chance to attract the attention of future investors. “Crowdfunding may help some start-ups financially even as it may jeopardize their intellectual property strategies and implementation. To minimize this harm start-ups will need to develop strong investor relations staff th at can manage the expectations of disparate Crowdfunders even before the offering takes place” (O'Connor, 2014, p. 24). These are few determinants that potential future start-up creator should take into account deciding to make crowdfunding source of financial support: knowledge on efficient communication with Web 2.0, using network as extensively as possible, knowing what skills future company could benefit from and looking for these skills among potential investors, motivating shareholders to active participation in project and knowledge of legal restrictions (Schwienbacher & Larralde, 2010, p. 19) .

6. CONCLUSIONS

Dynamic development of crowdfunding platforms and development of the whole market segment has the potential to improve the financial environment for entrepreneurs, business owners of micro-enterprises and start-ups. Crowdfunding is a prospective method of financing projects or business ventures. It became a source of capital acquisition, an alternative to the existing ways of funding (banks, stock exchanges, incubators, etc.). This creates the possibility of obtaining economic benefits for a variety of different operators in the market, but on the other hand - as shown - comes up against many barriers to development, especially economic and legal. Creating such electronic platforms is beneficial from an economic point of view - they fill certain niches , increase the speed of financial transfers, their volumes and values, reducing transaction costs. Awareness of crowdfunding mechanism, safety and comfort behind the transaction will be key for the market to realize its potential.

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